

Teacher Retirement System
of Texas

1000 Red River Street
Austin, Texas 78701-2698

EXECUTIVE SECRETARY
Wayne Blevins, Ed.D.



RQ-482

William Baker, General Counsel

January 13, 1993

MBJ
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FD #18503

HAND DELIVERED

The Honorable Dan Morales
Attorney General of Texas
Price Daniel Senior Building
14th & Lavaca, 7th Floor
Austin, Texas 78711
Attention: Madeleine B. Johnson
Chair, Opinion Committee

RE: Opinion request of the Teacher Retirement System of Texas
regarding its authority with respect to certain real estate
related investments.

ID #17453

Dear Attorney General Morales:

On September 25, 1992, the Teacher Retirement System of Texas ("TRS") asked your opinion on options facing it with respect to assets held in its real estate related portfolio. This letter addresses legal issues raised in the request. It is the position of TRS that both of the proposed transactions are within its authority.

The opinion request raises significant questions for the retirement system in dealing with any troubled mortgage loans or with real estate acquired as a result of a borrower's default. The response could also clarify the system's ability to hold real estate related investments other than mortgages.

The Texas Supreme Court has ruled that teacher retirement law "should be liberally construed in order to effectuate the whole purpose of the plan." Woods v. Reilly, 147 Tex. 586, 218 S.W. 2d 437, 442 (1949). The retirement system is a trust whose assets are relied upon as the source of benefits for plan participants. Tex. Const. article XVI, §67.

Investments now account for over 50% of TRS annual income. TRS, August 31, 1991 Component Unit Financial Report 72-73 (1991). See Attachment 1. Funding of the system must be based upon sound actuarial principles. The actuarial rate of return of the system is assumed by the Board of Trustees as provided by law to be 8% per year. Id. at 57. Minutes of the Board of Trustees of the Teacher Retirement System, 53 TRS Minute Book 579 (January 23, 1991). The investment performance of TRS in the past decade exceeding the actuarially assumed return has largely accounted for a number of substantial

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benefit improvements and post retirement increases while keeping the system actuarially sound. The TRS real estate portfolio which presently comprises 6.5% of the total portfolio has realized an 8.98% average annual return since the first real estate mortgage (June 30, 1984 through June 30, 1992). The Roulac Group of Deloitte & Touche, TRS Real Estate Portfolio Performance Report, Twelve Months Ending June 30, 1992 at 2 (1992). See Attachment 2.

Fiduciaries of trusts are required to diversify their holdings. Restatement (Third) of Trusts §227(b) (1992). The TRS real estate portfolio is generally designed to serve a well recognized strategic purpose for a pension trust portfolio. See TRS, *Investment Manual*, "Policy Objectives" 17 (1992). See Attachment 3. "The logic for holding real estate assets in a portfolio is strong. It functions well as a hedge against inflation. In addition, with real estate comprising over half of all the wealth in the United States, its claim to some share of the 'market' that should be held to avoid diversifiable risk is clear." B. Longstreth, *Modern Investment Management and the Prudent Man Rule* 128 (1986). See also Restatement (Third) of Trusts §227, comment o (1992). To accomplish such objectives, the TRS real estate investments are generally "participating" real estate mortgages (i.e. mortgages whose returns increase with the improved performance of the property and appreciation in market value). Thus, although TRS invests in real estate mortgages, it has structured these investments to accomplish objectives similar to those which real estate equity holdings are designed to meet.

The Texas Constitution makes the TRS trustees responsible under the prudent person rule and other fiduciary principles for the management of the TRS trust fund. Tex. Const. article XVI, §67(a)(3). The prudent person rule was developed to give trustees wider discretion in managing assets of the trust in the interest of the beneficiary. The questions in the opinion request should be answered with this purpose, the needs and objectives of the pension trusts applicable fiduciary principles, and the liberal construction rule of Woods v. Reilly in mind.

Consistent with its fiduciary responsibilities, TRS is considering two potential actions with respect to its real estate holdings which are designed to avoid excessive costs and assure effective TRS control of an asset in one instance and to increase the profitability and value of certain foreclosed property in another instance. See Restatement (Second) of Trusts §181 (1959) (regarding the duty to make assets productive) and §188, comment f (1959) (regarding the fiduciary duties to minimize losses and incur reasonable costs). Also see the memorandum from Chuck Lathem of the TRS Real Estate Department dated October 12, 1992 outlining the importance of this matter to TRS. (Attachment 4.)

TRS submits the following comments and arguments with respect to its questions to you on these matters:

1. The described procedure by which TRS would acquire an interest in

the general partner of the borrowing entity itself is not an "investment" and therefore does not violate any requirement that TRS invest only in securities.

A longstanding legal definition of "investment" is "the placing of capital or laying out of money in a way intended to secure income or profit from its employment." SEC v. W.J. Howey, Co., 328 U.S. 293 at 298, 66 S. Ct. 1100 at 1102, 90 L. Ed. 1244 (1946); Brown, et al. v. Computer Technology Serv., Inc., 1988 WL 25472 (D.D.C. 1988). Other than costs associated with organizing the title-holding corporation, TRS will not place additional capital at risk or lay out additional sums of money over and above the remaining principle and unpaid accrued interest on its original loan in order to acquire its interest in the general partner of the project. Its purpose in obtaining this interest is to acquire as efficiently as possible effective control over the project so that it can under the circumstances maximize the return on its true investment--the mortgage loan to the borrower. The proposed acquisition of control over the property is similar for purposes of this question to the acquisition of the property by deed in lieu of foreclosure. Trustees generally have the power to compromise claims of the trust. Restatement (Second) of Trusts §192 (1959).

2. The described procedure by which TRS would acquire an interest in the corporate general partner of its borrower, even if it were deemed to be an investment, would comply with any requirement that TRS invest in securities because the interest held by TRS would be in the common stock of a general partner. In the proposed arrangement either TRS and the other public pension fund would each own proportionate shares of the common stock of the corporation serving as the sole general partner or, alternatively, each own all the common stock of corporations respectively serving as the general partners of borrower. Common stock of corporations are commonly recognized as "securities."

Op. Tex. Att'y Gen. No. MW-152 (1980) ruled that TRS investments were constitutionally required to be in "securities" that the TRS Board deemed to be prudent.¹ If an interest in real estate or in a

¹The retirement system does not necessarily concur with Op. Tex. Att'y Gen. No. MW-152 (1980). TRS would argue that the constitutional language was not intended as a limitation. The entire thrust of article XVI, §67 of the Texas Constitution was to expand the investment authority of public retirement systems subject only to the prudent person rule. It makes no sense for the many local public pension systems in the State of Texas to be permitted, as they are, to invest in real estate subject only to the prudent person standard while such investments are prohibited to the largest pension funds in the state. TRS is the 7th largest public pension fund in the nation and the 11th largest public or private pension plan in the United States. *Pension &*

partnership can be properly classified as a "security" and a prudent investment, it is a permissible investment for TRS. For example, the Attorney General ruled that certain interest in real estate--real estate mortgages--were permissible investments. Certain limited partnership interests in real estate are securities. Mayfield v. Troutman, 613 S.W. 2d 339 (Tex. Civ. App.--Tyler 1981, writ ref nre). It is clear that an interest in real estate may be fashioned so that an investment in it would be an investment in a security. Neither the constitution nor Op. Tex. Att'y Gen. No. MW-152 (1980) prohibits investments in real estate per se but simply refers to (or, in case of the opinion, requires) investing in securities.

Courts have recognized that use of a corporate organization may validate arrangements which would otherwise be impermissible, as in the case of avoiding violation of usury laws. Am. Century Mortgage Investors v. Regional Center, Ltd., 529 S.W. 2d 578 (Tex. Civ. App.--Dallas 1975, writ ref'd nre); Skeen v. Glenn Justice Mortgage Co., Inc., 526 S.W. 2d 252 (Tex. Civ. App.--Dallas 1975, no writ).

Because the first proposed transaction would consist of acquiring an interest in the securities (common stock) of a corporation serving as a general partner of the borrower it would satisfy any applicable requirement that TRS investments be in securities.

With respect to the second transaction, the acquisition of adjacent property necessary for the improvement of existing property, the commitment of additional funds should not be viewed as prohibited under article XVI, §67(a)(3). TRS may have several options with respect to acquiring and holding the additional property in the form of a security. Pursuant to its powers and privileges of a corporation, Tex. Gov't Code, §821.004, TRS can contribute capital to the existing title-holding corporation which could use such capital to acquire the property. Alternatively, the funds could be paid to the corporation in exchange for the issuance of additional common stock by the corporation. If the adjacent property were itself held by a corporation, TRS or its existing subsidiary corporation might purchase the stock of that corporation, perhaps subsequently transferring the property to the existing subsidiary corporation or to another tax-exempt title-holding subsidiary corporation and dissolving the acquired corporation. Any of these arrangements would meet any constitutional requirement that TRS investments be in securities because any investment of TRS funds would be in corporations whose securities it or its corporate subsidiaries

Investments, Jan. 20, 1992, pp. 20, 34. The result of Op. Tex. Att'y Gen. No. MW-152 (1980) has been to restrict the ability of the pension fund to diversify its investments as a truly prudent investor must do. The opinion has thwarted the reasonable purpose of adopting the prudent person rule.

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3. A possible agreement not to sell the project in the first described transaction for a period of five to ten years does not violate the fiduciary principle that a trustee must prudently dispose of any impermissible investments. The proposed arrangement is not an impermissible investment.
4. Some authorities have held that general partnership interests are inherently imprudent investments for a trust generally because the trust should not be subjected to unlimited liability and other risks associated with carrying on a business. See Bogert, Trusts and Trustees §679 (1982). Since TRS would hold a security (common stock) issued by a general partner it would not itself have a direct partnership interest and thus risks would seem appropriately limited. Further, the liabilities of the partnership could be reduced by obtaining certain releases from the limited partners. The Texas Trust Code explicitly permits trustees to participate in and effect changes in business enterprises including partnerships. Tex. Prop. Code, §113.008 (Vernon 1984). Thus, the proposed acquisition of an interest in a general partner is not per se a violation of the TRS trustees' fiduciary duties.

Please contact me if you need further information.

Yours very truly,



William H. Baker

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Attachments